

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69684; File No. SR-BX-2013-016)

June 3, 2013

Self-Regulatory Organizations; NASDAQ OMX BX Inc.; Order Instituting Proceedings to Determine Whether to Approve or Disapprove the Proposed Rule Change to Adopt a Directed Order Process

I. Introduction

On February 21, 2013, NASDAQ OMX BX Inc. (“Exchange” or “BX”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to establish a directed order process. The proposed rule change was published for comment in the Federal Register on March 11, 2013.³ The Commission received a comment letter from one commenter on the proposal,⁴ a letter responding to the comment,⁵ and a follow up comment letter from the same commenter.⁶ In addition, on April 17, 2013, the Exchange filed Amendment No. 1 to the proposed rule change.⁷ On April 22, 2013, the Exchange extended to

¹ 15 U.S.C. 78a.

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 69040 (March 5, 2013), 78 FR 15385 (March 11, 2013) (“Notice”).

⁴ See Letter, dated April 2, 2013, to the Commission from Janet McGuinness, Executive Vice President, Secretary and General Counsel, NYSE Euronext (“NYSE Letter”).

⁵ See Letter, April 17, 2013, to the Commission from Edith Hallahan, Principal Associate General Counsel, BX (“BX Response Letter”).

⁶ See Letter, dated May 10, 2013, to the Commission from Janet McGuinness, Executive Vice President, Secretary and General Counsel, NYSE Euronext (“NYSE Response Letter”).

⁷ Amendment No. 1, which the Commission believes is technical in nature and not subject to notice and comment, clarifies that, when a Directed Order (as defined below) is submitted in an options class that is subject to the price/time priority on the Exchange, the

June 6, 2013, the time period within which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change. This order institutes proceedings under Section 19(b)(2)(B) of the Act to determine whether to approve or disapprove the proposed rule change.

II. Description of the Proposal

The Exchange proposes to establish a directed order process that would permit members of the Exchange (“BX Participants”) to direct orders (“Directed Orders”) to a particular market maker on the Exchange (“Directed Market Maker”).⁸ Under the proposed rule change, a Directed Order that could not be executed upon receipt would be placed on the BX book and would retain its status as a Directed Order.⁹ Further, a Directed Market Maker would remain eligible to be allocated a percentage of the Directed Order at all price levels at which the Directed Market Maker has a quote or order (a “Directed Allocation”).¹⁰ To receive a Directed Allocation, the Directed Market Maker would be required to have quotes or orders at the National Best Bid or National

Directed Market Maker’s Directed Allocation (as defined below) would be capped at 40%, unless the Directed Market Maker’s size at the first position in time priority at that price exceeds 40%, in which case the Directed Market Maker would have priority for that size.

⁸ Specifically, BX proposes to add Chapter VI, Section 1(e)(1) to Chapter VI to define a Directed Order as “an order to buy or sell which has been directed (pursuant to the Exchange’s instructions on how to direct an order) to a particular Market Maker (“Directed Market Maker”) after the opening.” BX’s also proposes to amend Chapter VI, Section 6(a)(2) to include Directed Order to the list of orders handled within the BX System.

⁹ Chapter VI, Section 10(3)(iv)(C). For example, as shown in Example 6 in the Notice, if a non-routable Directed Order to buy is received on BX and BX is not quoting at the NBO, the order would be posted on the BX Book. If the market moves such that BX and Directed Market Maker are quoting at the NBO, the Directed Order would be executed against the BX Book and the Directed Market Maker would receive a 40% allocation of the Directed Order.

¹⁰ Chapter VI, Section 10(3)(iv)(C).

Best Offer (“NBBO”) at the time of the execution of the Directed Order; the Directed Market Maker would not be required to be quoting at the NBBO at the time the Directed Order is received.¹¹

The calculation of a Directed Market Maker’s Directed Allocation would depend on whether the Directed Order is submitted in an options class that is subject to price/time priority or in an options class that is subject to the size pro-rata execution algorithm on the Exchange. Specifically, if a Directed Order is submitted in an options class that is subject to price/time priority, a Directed Market Maker who has time priority at a particular price would receive the amount of the Directed Order equal to the Directed Market Maker’s quotes or orders with time priority at that price.¹² However, if the Directed Market Maker does not have time priority for a size equal to or greater than 40% of the Directed Allocation, the Directed Market Maker would be eligible to receive 40% of the Directed Order at each price level at which there is an execution and at which the Directed Market Maker has quotes or orders.¹³ The Exchange further proposes to allocate the remainder of the Directed Order to the other participants in price/time priority sequence, including any remaining contracts of the Directed Market Maker and multiple quotes or orders from the same firm.¹⁴

¹¹ For example, as shown in Example 4 in the Notice, a Directed Market Maker that was not at the NBO when the Directed Order was received on the Exchange, would receive a Directed Allocation at the next price level below the NBO if the quotes or orders at the NBO were exhausted.

¹² Chapter VI, Section 10(3)(i)(A). See Amendment No. 1, supra note 7.

¹³ If there are multiple resting quotes or orders from the same Directed Market Maker, the Directed Market Maker would receive the Directed Allocation (up to 40% of the Directed Order) distributed among those quotes or orders on a time priority basis. Chapter VI, Section 10(3)(i)(A).

¹⁴ Chapter VI, Section 10(3)(i)(A).

If a Directed Order is submitted in an options class that is subject to the size pro-rata execution algorithm, any Public Customer limit orders resting on the limit order book at the execution price would first be executed against the Directed Order.¹⁵ Once all Public Customer limit orders are executed, the Directed Market Maker would receive the greater of: (1) the pro-rata allocation to which such Directed Market Maker would be entitled or (2) the 40% of the Directed Order at that particular price.¹⁶ Once the Directed Allocation is determined, the Exchange proposes to allocate all remaining contracts of the Directed Order on a size pro-rata basis among all remaining participants (except for the Directed Market Maker).

The Directed Market Maker would not be entitled to receive a number of contracts that is greater than the size associated with its quote or order at a particular price.¹⁷ In addition, if the calculation of the 40% Directed Allocation results in a fractional remainder, the Exchange proposes to round up the Directed Market Maker's Directed Allocation to the next whole number whether the Directed Order is submitted in an options class subject to price/time priority or in an options class that is subject to the size pro-rata execution algorithm.¹⁸

The Exchange also proposes to reduce the quoting obligations applicable to its Market Makers but subject Directed Market Makers to heightened quoting requirements. Currently, BX Market Makers are required to quote during regular market hours on a continuous basis (i.e., 90% of the trading day) in at least 60% of the series in options in which the Market Maker is registered. The proposed rule would reduce this requirement such that Market Makers would be required to

¹⁵ Chapter VI, Section 10(3)(i)(B).

¹⁶ If there are multiple quotes or orders for the same Directed Market Maker, the Exchange would distribute the Directed Allocation among those quotes or orders on a size pro-rata basis. Chapter VI, Section 10(3)(i)(B).

¹⁷ Chapter VI, Section 10(3)(iv)(A).

¹⁸ Chapter VI, Section 10(3)(iv)(B).

quote 60% of the trading day (as a percentage of the total number of minutes in such trading day) or such higher percentage as BX may announce in advance, in all options in which the Market Maker is registered. Compliance with the obligation that a Market Maker quote 60% of each trading day in all options in which it is registered would be determined on a monthly basis.¹⁹

Directed Market Makers, however, would be required to quote such options 90% of the trading day (as a percentage of the total number of minutes in such trading day) or such higher percentage as BX announces in advance, applied collectively to all series in all of the options in which the Directed Market Maker receives Directed Orders (rather than on an option-by-option basis). The Directed Market Maker would be required to comply with the heightened quoting requirements only upon receiving a Directed Order and the heightened quoting requirements would be applicable until the end of the calendar month. Compliance with the obligation that a Directed Market Maker quote options in which they have received a Directed Order 90% of each trading day would be determined on a monthly basis.²⁰

III. Summary of Comments

In its comment letter on the proposed rule change, NYSE Euronext (“NYSE”) raises two primary concerns regarding the Exchange’s proposal.²¹ First, NYSE argues that a provision in the proposed rule that applies to options classes with price/time priority is vague and that, accordingly, could be interpreted to imply that as long as a Directed Market Maker establishes time priority for at least one contract, all of the Directed Market Maker’s interest at that price will be accorded time priority over all other interest in the book at that price. NYSE believes

¹⁹ Chapter VII, Section 6(d)(i)(4).

²⁰ Chapter VII, Section 6(d)(i)(4).

²¹ See NYSE Letter, supra note 4.

that providing Directed Market Makers with this time priority could result in the Directed Market Maker receiving a 100% Directed Allocation. NYSE suggests a modification of BX's proposal to clarify that "the Directed Market Maker will receive only the size he/she has at the first position in time priority, plus up to 40% of the remainder of the Directed Order" (emphasis in original).²²

In response to NYSE's concerns, the Exchange submitted a letter and an amendment to its proposal.²³ In its response, the Exchange explains that the language related to Directed Market Makers receiving 100% of a Directed Allocation when the Directed Market Maker is first in time was intended to address the scenario when a Directed Market Maker already has time priority and a Directed Allocation is not needed. Therefore, BX explains that "a Directed Market Maker cannot use a small quote/order to 'jump the queue' by later submitting a larger quote/order at the same price, because priority afforded via Directed Allocation is limited to the 40% calculation."²⁴ BX submitted Amendment 1 to clarify this point in its proposed rule text and discussion of its proposed rule change.²⁵

²² See NYSE Letter, supra note 4, at 3.

²³ See BX Response Letter, supra note 5 and Amendment 1, supra note 7.

²⁴ See BX Response Letter, supra note 5, at 1.

²⁵ In its comment letter, NYSE raises additional concerns about BX's proposal based on the interpretation that the Exchange's proposed rule could permit 100% internalization. These concerns relate to opportunities for selective quoting and use of price improving orders, as well as concerns relating to information barriers that govern permissible communication between the market making function of a broker-dealer and other divisions within a broker-dealer, such as an order sending affiliate. Id. at 3-5. The Exchange notes that these additional concerns are based on NYSE's interpretation of the proposed rule and that, given that the Directed Allocation will not function the way NYSE understood, NYSE's additional concerns are not applicable. See BX Response Letter, supra note 5, at 2.

NYSE also expressed concern with the Exchange’s proposed rule to allow a Market Maker to receive a Directed Allocation when the Market Maker does not have a quote at the NBBO at the time the Directed Order is received by the Exchange. NYSE believes that the proposal enables a Market Maker to “lay in wait outside the NBBO, allowing other participants to participate in the order at less attractive prices.”²⁶ The Market Maker would then receive a 40% guarantee for that portion of the Directed Order that trades beyond the initial NBBO. NYSE argues that this rule would be unprecedented and recommends that the Exchange stipulate that a preferential Directed Order allocation of any kind is only available to Market Makers who have a quote or order at the NBBO at the time the Directed Order is received by the Exchange.

In response to this concern, the Exchange recognizes that its proposal does break new ground, but stresses that in order to receive an execution of a Directed Order, a Directed Market Maker must be quoting at the NBBO at the time of execution, and that there would never be an allocation to a quote outside the NBBO.²⁷ The Exchange argues that its proposal addresses the reality of multiple prices and creates an ability to efficiently execute a larger volume of an order. The Exchange further maintains that it “recognizes the new NBBO and preserves the requirement that the Directed Market Maker be at the NBBO” (emphasis in original).²⁸ The Exchange believes that availability of a certain depth of a quote beyond the current NBBO is an important aspect of price discovery, particularly with respect to execution of larger orders when the NBBO is for a small size. Therefore, the Exchange argues that its proposal provides preferential allocation to Market Makers who are fostering price discovery and transparency by

²⁶ See NYSE Letter, supra note 4, at 5.

²⁷ See BX Response Letter, supra note 5, at 2.

²⁸ Id. at 3.

taking the commensurate risk of quoting at the NBBO at the time of execution of the Directed Order. Accordingly, the Exchange maintains that Directed Market Makers will continue to have the incentive to quote aggressively to maximize their participation.

In its second letter, NYSE states that the Exchange's response was inadequate and the concerns regarding allowing Directed Market Makers to receive a Directed Allocation when the Directed Market Maker's quote is not at the NBBO persist. NYSE argues that the proposed rule change, by rewarding market makers whose quotes are not the most aggressive, will encourage market makers to quote away from the inside market.²⁹ In addition, NYSE asserts that the proposed rule change raises concerns "that are even more troubling than those held by the Commission and staff for more than a decade about the tendency of passive price matching behavior to degrade price competition in options markets."³⁰ As a result, NYSE believes that allowing the Exchange's proposal would deteriorate market makers' incentives to compete for incoming orders based on price.

NYSE also raises a concern with the Exchange permitting Directed Allocations to a Directed Market Maker before a Public Customer when the Directed Market Maker is not first-in-time. NYSE notes that, under the Exchange's proposal, a Directed Market Maker that arrives after a Public Customer who has aggressively improved the NBBO would receive a Directed Allocation of an order that the earlier-arriving Public Customer could potentially have completely filled. According to the NYSE, public customers would not be fully rewarded for

²⁹ See NYSE Response Letter, *supra* note 6, at 1.

³⁰ *Id.* (citing Special Study: Payment for Order Flow and Internalization in the Options Markets, Office of Compliance Inspections and Examinations and Office of Economic Analysis (Dec. 2000). Indeed, the NYSE notes that BX would not even require a Directed Market Maker to passively price match – *i.e.*, promising to match the price of the NBBO – to receive a Directed Allocation.

providing an aggressive quote and thus the incentives to improve the NBBO would decrease, resulting in fewer displayed public customer orders and fewer public customers willing to improve the NBBO. NYSE describes the longstanding history of distinguishing public customers from professionals and allowing advantages to public customer orders.³¹ NYSE provides NYSE Arca Inc. and NYSE Amex Options LLC as examples of exchanges that use the “appropriate approach” of maintaining incentives for public customers willing to aggressively quote, especially when public customer orders are ranked ahead of a Directed Market Maker’s order. Specifically, NYSE Arca Inc. does not award the Lead Market Maker the 40% participation entitlement they would otherwise receive, but instead grants strict time priority to the customer, thus ensuring that customers aggressively improving the NBBO are fully rewarded.³² Under the rules of NYSE Amex Options LLC, customer orders have priority for incoming Directed Orders, even if the market maker has time priority.³³

IV. Proceedings to Determine Whether to Approve or Disapprove SR-BX-2013-016 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. Institution of these proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described in greater detail in Section V below, the Commission seeks and encourages interested persons to

³¹ See NYSE Response Letter, supra note 6, at 2.

³² See NYSE Response Letter, supra note 6, at 4 (citing NYSE Arca Options Rule 6.76A).

³³ See NYSE Response Letter, supra note 6, at 4 (citing NYSE MKT Rule 964NY).

provide additional comments on the proposed rule change to inform the Commission's analysis of whether to approve or disapprove the proposed rule change.

As described above, the Exchange's proposed Directed Order process would enable a Directed Market Maker to be eligible to receive a Directed Allocation regardless of whether the Market Maker is quoting at the NBBO at the time the Directed Order is received. The Directed Allocation would be available for the life of the Directed Order. If the Directed Market Maker does not have time priority for a size equal to or greater than the Directed Allocation at a particular price that is the NBBO, the Directed Market Maker would be entitled to a Directed Allocation, regardless of time priority. Further, the Directed Market Maker would be entitled to a Directed Allocation at all price levels at which the Directed Market Maker has a quote or order. In addition, when a Directed Order is submitted in an options class that is subject to the price/time priority on the Exchange, the Exchange would provide Directed Market Makers with priority for the Directed Allocation ahead of any Public Customer limit orders, including those that arrived prior to the Directed Market Maker's quotes or orders at that price. In addition, if the calculation of the 40% Directed Allocation results in a fractional remainder, the Exchange further proposes to round up to the next whole number. Further, the Directed Market Maker would be subject to heightened quoting requirements only upon receiving a Directed Order, it would not be required to meet those requirements beforehand. The Exchange also proposes to reduce the quoting obligations applicable to its Market Makers.

Pursuant to Section 19(b)(2)(B), the Commission is providing notice of the grounds for disapproval under consideration. The section of the Act applicable to the proposed rule change that provide the grounds for approval or disapproval under consideration are Section 6(b)(5)³⁴

³⁴ 15 U.S.C. 78f(b)(5).

and Section 6(b)(8).³⁵ Section 6(b)(5) of the Act requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers. Section 6(b)(8) of the Act requires that the rules of the exchange do not impose any burden on competition not necessary or appropriate in furtherance of the Act.

The Commission believes that the Exchange's proposal raises questions as to whether the proposed rule change is consistent with these standards. Specifically, the Commission questions whether, and if so how, the proposed rules could impact quote competition on the Exchange. The Commission also questions whether, and if so, how, any impact on quote competition on the Exchange could impact execution quality on the Exchange. In addition, the Commission questions whether BX's proposal is designed to protect investors in that the proposal would provide Directed Market Makers with priority for Directed Allocations ahead of Public Customer limit orders that arrived first in time.

V. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the concerns identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Section 6(b)(5)³⁶

³⁵ 15 U.S.C. 78f(b)(8).

³⁶ 15 U.S.C. 78f(b)(5).

or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval which would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.³⁷

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by [insert date 35 days from publication in the Federal Register].

The Commission asks that commenters address the sufficiency and merit of the Exchange's statements in support of the proposal, in addition to any other comments they may wish to submit about the proposed rule change. In particular, the Commission seeks comment on the following:

1. Unlike the Directed Order rules of other options exchanges, the Exchange's proposed rule would not require that a Directed Market Maker be quoting at the NBBO at the time a Directed Order is received. The Commission seeks comment on whether this aspect of the proposed rule change would impact market makers' incentives to quote competitively on the Exchange. If so, how? If not, why not? If the Commission were to approve this aspect of the proposed rule change and if other options exchanges also eliminated the requirement that

³⁷ Section 19(b)(2) of the Act, as amended by the Securities Act Amendments of 1975, Pub. L. 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding - either oral or notice and opportunity for written comments - is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Act Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

Directed Market Makers quote at the NBBO to receive Directed Orders as part of their Directed Order process, what, if any, impact could there be more generally on the quality of quotations in the options markets?

2. In support of not including an NBBO quoting requirement, the Exchange argues that availability of quotes beyond the current NBBO is an important aspect of price discovery, particularly with respect to execution of larger orders when the NBBO is for a small size. The Exchange further argues that its proposal “acknowledges and addresses the reality of executions at multiple prices” and creates an ability to efficiently execute a larger volume of an order. Therefore, the Exchange argues that its proposal provides preferential allocation to Market Makers who are fostering price discovery and transparency by “taking the commensurate risk of quoting at the NBBO at the time of execution of the Directed Order.” Do commenters have any views regarding the Exchange’s arguments? If so, please explain.

3. NYSE argues that, because of the lack of an NBBO quoting requirement, “BX Market Makers will be able to lay in wait outside the NBBO, allowing other participants to participate in the order at less attractive prices and then receiving a 40% guarantee for that portion of the Directed Order that trades at more attractive prices (from the Market Maker’s standpoint) beyond the initial NBBO,” and this will destroy incentives for Market Makers to quote aggressively at the NBBO. However, the Exchange argues that Market Makers will continue to have the incentive to quote aggressively to maximize their participation and that quoting outside of the NBBO contributes to the market by providing depth and the ability to execute more of an order, especially where the NBBO size is small. Do commenters have any views regarding the NYSE’s or the Exchange’s arguments? If so, please explain.

4. Under the proposed rule, a Directed Market Maker to whom an order is directed in an option subject to price/time priority would receive a 40% allocation ahead of orders of other market participants, including customer orders that had time priority over the Directed Market Maker's quotation. What are commenters' views on this aspect of the proposal? Does this aspect of the proposed rule change impact the protection of investors? If so, how? If not, why not? Does this aspect of the proposed rule change have any impact on the options markets as a whole? If so, please explain.

5. NYSE notes that, under the Exchange's proposal, a Directed Market Maker that arrives after a Public Customer who has aggressively improved the NBBO would receive a Directed Allocation of an order that the earlier-arriving Public Customer could potentially have completely filled. NYSE argues that this provision would reduce the incentives of public customers to improve the NBBO, resulting in fewer displayed public customer orders and fewer public customers willing to improve the NBBO. Do commenters have any views regarding the NYSE's arguments? If so, please explain.

6. Under the proposed rule change, a Directed Order would remain as such as long as it exists on the Exchange and the Directed Market Maker would be eligible for a Directed Allocation at all price levels at which the Directed Market Maker has a quote or order. Do commenters have any views on whether this aspect of the proposed rule change would have an impact on quote competition on the Exchange? If so, how so? If not, why not?

7. Unlike the Directed Order rules of other options exchanges that subject Directed Market Makers to heightened quoting obligations prior to receiving Directed Orders, the Exchange's proposed rules would only subject a Directed Market Maker to heightened quoting obligations after receipt of the first Directed Order in a given month. Do commenters have any

views on whether this provision would balance the benefits of receiving enhanced allocations with heightened quoting obligations, consistent with the Exchange Act? Is so, please explain.

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number No. SR-BX-2013-016 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number No. SR-BX-2013-016. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of BX. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only

information that you wish to make available publicly. All submissions should refer to File Number No. SR-BX-2013-016, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁸

Kevin M. O'Neill
Deputy Secretary

³⁸ 17 CFR 200.30-3(a)(57).